

The Economy and Financial Markets: Mid-Year Report

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Presented by

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While we may or may not technically still be in a recession, it is clear that the global economy cannot yet be termed robust. The best description seems to be that we are hanging on. There is growth, and not just in the U.S., but it is quite tenuous. Most economists and commentators seem to agree that this most-recent recessionary period has been the worst since the great depression (1929 - 1938/39; although technically, the U.S. depression may have ended in 1933, with a following deep recession in 1937/38). While there is not enough information at present to accurately predict a *double-dip*, the possibility remains in the background of our economic situation.

In this paper I plan to highlight current economic conditions as well as events in global financial markets. Additionally, I will suggest reasons for stock market returns (or lack thereof) and a strategy or two for dealing with these things moving forward. Let's begin by taking a look at global economic conditions.

The Economy

How we got here

Several factors have been suggested as the primary cause of the current recessionary period. Certainly, one of the triggers was the unraveling of credit default swaps, along with the decimation of mortgage and (subsequently) housing markets. A companion contributor, and perhaps the prime cause, was the drying-up of credit markets with a resulting loss of liquidity. It is not an overstatement to say that modern economies require ready access to reasonably-priced credit. Without the liquidity provided by credit, the wheels of progress tend to grind to a halt.

Some examples may help clarify - one relating to consumers and another, to businesses. For the most part, economies are consumer-based. That is, if people don't purchase goods, the economy falters. While this comes as no surprise, the degree to which consumer-spending has become dependent on ready access to low-cost credit is a significant factor. Especially in the U.S., many consumers have gotten used to living beyond their means. A large part of GDP growth in recent years is a result of credit-driven purchasing. Not all of this is a negative. After all, how many of us would own a house without the ability to secure a mortgage? The negative part comes when consumers over-borrow, and this is what happened throughout a large part of the developed world.

Now, take a quick look backward to the last couple of years, where we experienced a dramatic tightening of credit availability. Consumer response was immediate and substantial. People stopped buying. When people stop buying, existing inventories hang around, and manufacturers stop manufacturing. When companies are not producing goods, there is little reason to maintain employee head-counts. So, layoffs ensued. This, of course, had the undesirable effect of further decreasing consumer spending, which led to further layoffs, and so on.

Additionally, when people lose their jobs, they cannot make payments on existing debt. As this happened, defaults on mortgages and other debt skyrocketed. When an individual defaults on a mortgage, the lender wants their house back. As this happened, existing home inventories increased,

further depressing the housing market. The fact that lenders wanted to get the houses off their books caused them to sell at below-market prices, continuing the decline in the housing market. All of this had an understandable impact on consumer confidence, which caused a further downward spiral in spending (albeit, with somewhat of an increase in saving rates).

We have already seen some of the impact on business. However, there is an even more direct implication of tight credit. Businesses need money to purchase equipment. They need money to build headquarters and furnish them. Hiring requires money. Many companies function on the basis of producing the goods or services first, then getting paid. As a result, a large majority of those companies use lines of credit to smooth out their cash flow. Under normal circumstances, this works quite well, as the credit essentially serves as a cash substitute. As soon as they receive payment, the company pays off its debt.

You already know where this is going. As credit tightened, the process identified above ground to a halt. Many small companies could not even complete existing orders, because they did not have the money to pay for raw materials. Neither did they have the funds to pay workers. Even when orders were delivered, the receiving company often did not have the money to pay for the goods.

These two examples help to show why recessions caused by a credit crunch or lack of liquidity require so much time for full recovery. This time, it actually was a little different, in that much of the world (rather than just the U.S.) was mired in the same situation. It became nearly impossible to find any country that was not adversely impacted.

The current economic environment

Today, we are still in the throes of credit/debt-related difficulties. All of the factors highlighted above continue to contribute to slow economic growth. Additionally, the degree to which sovereign governments increased debt has further depressed economic expansion.

The (at least somewhat) good news is that the world is grappling with, and addressing these concerns. Note that I did not say the various countries were solving their debt-related problems. In fact, the reverse is often true (but they are at least addressing the concerns). Many countries continue to struggle with increasing debt. Often, the concern is that business – and the country's economy – is not strong enough to survive a decrease in government spending. As a result, governments and central banks are treading cautiously as they approach their respective debt and interest-related situations. We may disagree with the process and rationale, but it, and the long-term implications, are currently facts of life.

Debt and inflation

Until the debt dilemma is addressed, global economies will continue to struggle. This is true from the federal level all the way to the consumer. On the one hand, we have depended (over much) on ready access to credit to boost our standard of living, and thereby the country's GDP. On the other hand, you do eventually have to pay the bills, and the cost of debt service – at all levels – is staggering. Governments, of course, have a simple debt-repayment solution (assuming they cannot sell enough bonds). Print money . . . or raise taxes . . . or both. One unfortunate side effect of this is inflation. It's

not so much that an increase in money supply actually causes inflation. Instead, when there is too much money (demand) chasing too few goods (supply), prices tend to rise. At present, consensus is that we are being set-up for a substantial cost-of-living increase.

At the moment, we are in no immediate danger of inflation. In fact, deflation is a bit more of a concern. Why? Deflation tends to create a downward spiral of people waiting for even lower prices and companies not producing additional goods, because they don't like the revenue they are receiving from sales. Eventually, the whole cycle reaches a balance, and begins to reverse itself (assuming money is available for purchasing goods and services).

Similar cycles have been going on for hundreds (if not thousands) of years, so this is no new phenomenon. It's also probably good to remind ourselves that neither the current administration, nor the previous one, is directly responsible for our financial condition. Certainly, both contributed. However, what we are experiencing today is the result of decades of less-than-optimal financial management — at all levels, from the government, to business, to individual consumers. Problems that developed over decades will not likely be solved in a year or two.

So we find ourselves in an economic environment with timid growth. Many corporations are showing positive revenue streams and improving profitability. Consumers are starting to spend (again, timidly). Housing is improving. Credit, when available, is being extended with fairly low interest rates. The employment picture, while still grim, is ever-so-slightly improving. Mortgage and other defaults are just as slightly decreasing (but they remain way too high).

As a result of all this “*good*” news, some economists are saying that we are no longer in a recession. Perhaps, but it seems that the financial markets are not so sure.

The Financial Markets

Many of us are at least as concerned about our investments as we are about the broader economy. So, we need to turn our attention to the financial markets. At the time of this writing, global markets have been experiencing a modest turnaround in what has been an overall downward trend. Year-to-date, the S&P 500 has varied between a high of 1217.06 and a low of 1032.95, reflecting a return of around -15%. Over the last quarter, even balanced mutual funds averaged around a -10% return. Thankfully, the recent up-trend has brought some welcome relief, raising the YTD return to about -3.02%. Still negative for the year, but improving.

Will the up-trend continue for the rest of the year? Not likely. I can almost guarantee that we will experience at least one more period of negative market performance. That said, there is a good possibility that we will see a pleasant fourth quarter growth trend, and the year will produce positive returns. Along the way, however, we are likely to experience continued volatility.

Portfolio Construction: Fundamental and Technical Analysis

Well-designed portfolios are constructed to balance risk and return. As applied, this balance usually has the effect of limiting potential movement to both the upside and the downside. In other words, there is a cost to caution, but the intention is that diversification and balance will limit losses. There is a key to this, and that key is time. I'm not talking about decades, but I am referring to periods greater than a few years (and definitely more than any given quarter). It generally takes time for the positive impact of a diversified and balanced portfolio to show itself. In shorter periods, it's entirely possible for otherwise solid investments to produce negative returns. Let me highlight one example that illustrates this better than I would wish.

Apollo Group

Many advisors, including me, focus on fundamental analysis. Summarized, fundamental analysis looks at a company's financials, management, products and market, potential for growth, and similar areas. The late Benjamin Graham – considered by many to be the greatest investor of modern times, and mentor to people like Warren Buffet – followed this approach. He also focused on buying stocks that were good values, relative to their fundamental strength. Graham largely rejected reliance on purely technical analysis, as being a form of speculation, rather than investment. On the other hand, Warren Buffet seems to incorporate some degree of technical analysis in an attempt to deal with timing issues (although it should be said that this seems to be a long way from Mr. Buffet's primary focus). Another precept of these investors, along with others such as Peter Lynch, is *buy what you know*. In a nutshell, this means that you have to have a good handle on a particular company before you considering adding it to your portfolio. I follow this same approach.

Enter the Apollo Group. If you take a look at the attached report (<http://wealthridge.com/msnowdon/apol.pdf>), you will see that Apollo comes highly recommended, and for good reason. It has solid management, tremendous growth history and future potential, strong financials, and positive investment returns. Also, last I checked, the Apollo Group had almost \$1 billion of cash on hand, and almost no debt. I can factor personal experience, too, since this is definitely a company with which I am familiar. For the last 10 years, Apollo Group has owned the College for Financial Planning, where I have served as part of the faculty.

As a result of all this positive information, I felt that Apollo Group would make a positive addition to our investment portfolios. As for the timing, fair value for Apollo's shares is \$106.00. A recommended price point at which to buy was \$74.20. I bought shares at \$66.00, which should have been a very good purchase price. It was not.

As it turned out, Apollo promptly decreased in value to a little more than \$44 per share. Two questions need to be answered now. First, why the drop and second, does this mean Apollo Group is a bad holding?

In my opinion, Apollo dropped for three primary reasons. First, and least significant, they lost an appeal in a federal investigation over how they compensated their admissions advisors. This resulted in a fine of several million dollars, but nothing they cannot cover. In other words, the fine was not that big a deal.

The second reason is more significant. There is speculation, and I agree, that short-sellers were trying to drive down the price of Apollo stock in order to make an oversized profit. While this has not been proven, there is more than a little evidence to suggest that is exactly what has been happening.

The third reason, and one with broad financial market implications, is negative investor sentiment.

Investor Sentiment

I mentioned fundamental analysis as the basis of sound investment decision-making above. Unfortunately, it is not the only factor involved – at least on the short-term (and here, short-term can be a period of many months – perhaps longer). Another major factor impacting investment returns is investor sentiment. That is, how people feel about the current market environment can significantly influence its direction. Call it, to some degree, self-fulfilling prophesy. When investors are *bullish*, they tend to shrug off negative news and thereby keep investments moving in an up-trend. However, when they are *bearish*, investors can discount positive news and developments to the extent that they have little impact on investments. This results in an on-going downward trend.

Over much of this year, this bearish, negative sentiment has reigned. Apollo Group certainly has been the recipient of the unwelcome attitude. Lots of other investments have as well. The result has been negative returns over the last two quarters.

To be sure, some negativity has been based on reality. The global economies are not in such great shape. However, as I mentioned at the start, things really are improving – slowly and gradually, but there is definitely improvement.

In the near-term, however, actual economic conditions can have less of a market impact than consumer sentiment. That is, what people feel, can override actual conditions. In many ways, it comes down to supply and demand. The more people want an investment (demand), the higher the price can climb. However, the reverse is also true, and we are currently experiencing its impact. The more that people want to get rid of an investment, supply increases and prices drop. There is not necessarily a direct correlation of the current price of an investment position to its true/fundamental value.

In the case of Apollo, and quite a few other positions, this has resulted in temporarily reduced stock prices. Over the long-term, stocks of companies that are fundamentally sound should live up to their promise. Reaping the benefit will require investor patience, as well as a change in overall investor sentiment from negative (bearish) to positive (bullish).

One more example

Another very brief example will help to show the inherent difficulty in making short-term decisions. A very bright, successful investment manager I know recently noted one of his positions. Given the situation in Europe, he said that he was short the Euro. When you short an investment, you want to profit from it going down (which obviously, you believe it will do). At the time, this seemed to be a very wise decision. Pretty much everyone believed that the Euro would continue to drop in value. However, since that time, the reverse has happened. Against all odds, the Euro is up – and substantially. The

downside to being short and investment is that while you can make a nice profit if you're right, losses can be substantial if you are not. So, if he was not able to close out his position, and the Euro continues to rally, he may well be looking at some nasty losses.

I do not bring this up to make someone look bad. Rather, I bring it up to highlight how difficult making short-term investment decisions can be. Even very bright, very successful and experienced professionals get it wrong . . . and it doesn't take a genius to understand why. No one has the ability to accurately and consistently predict the future. If this is true, what can be done to manage your investment portfolio so that you get the best possible returns with the lowest reasonable amount of risk? In other words, is it even possible to plan for the future and achieve your goals in the current economic and financial market environment?

Implications and Strategies

Let me answer the preceding question with an absolute yes! While it is true that we probably all need to temper our investment return expectations in light of the current reality (or, as PIMCO calls it – *the new normal*), there is no reason to throw in the towel. Let's get the bad news out of the way first. The events of the last two years essentially erased 10 years worth of investment returns. The latter half of 2009 showed an impressive gain, but still not back up to par. Further, returns for the first two quarters of 2010 have been negative. All of this means that if your portfolio is anywhere close to a negative 5-10% to a positive 5% return, you are in good company, and at a reasonable place to begin moving forward.

Let me interject a reminder here. What we have just experienced has happened only one other time in 80 years of stock market history. It is safe to say two things. First, we should not expect a repeat performance of the huge stock market drop anytime soon. Second, we should not base future plans on this most recent period. It would be good to remember that every prior period of sustained stock market gains (i.e., a bull market) has been preceded by a significant negative return environment (bear market).

I am not going to try predicting the nature of the long-term recovery. However, I can say with reasonable confidence, that investment returns in the 3-5% above inflation range are definitely achievable. Before you look at those percentages and say they're too low, remember that *real* return is more important than *nominal* return. Real return is what you get to keep. That is, your return after subtracting the impact of inflation. Nominal return just reflects the raw return numbers. Also, this does not mean that in any given year, performance will not be quite a bit higher than 3-5% above inflation. Here's the historical data: From 1950 through 2009, the S&P 500 had a nominal return (without dividend yields) of about 7.0%. During that same period, the inflation rate was about 4.0%. This means that an investor's 7% nominal return was a 3.0% real return. Adding yields from dividends improves the total return picture, but you get the idea.

So if our target is a real (inflation-adjusted) annualized return of 3-5% (which in nominal terms could {for example} be anywhere from 1% to 20%), plus dividend yields, what's the best approach to get those returns?

An investment strategy

I am a fan of Benjamin Graham. His book, *The Intelligent Investor* is a classic, full of sound and useful investment advice. Mr. Graham generally recommends a balanced, diversified approach that focuses on the value end of the investing spectrum. We can define *value* in this context as referring to those investments that meet our core fundamental requirements, and are currently priced in such a way as to make them relative bargains. I will refer again to the Apollo Group example, where I followed a value strategy, to state again that short-term growth does not always (or often) result from following this approach. Longer-term, though, this approach usually pays off. It keeps you away from the realm of speculation, and forces a disciplined investment process.

The balance to which Mr. Graham refers varies between a 25% and 75% equity/fixed income allocation. The percentages varying based, to large degree, on where the best returns with the least risk are to be found. When bonds (or other fixed income instruments) are producing the higher returns, portfolio bias should be in that direction. The converse, when stocks are producing the higher returns – keeping risk profiles in mind – they should have the greater percentage. For many people today, a 60/40% equity/fixed income allocation makes sense.

I would add that, in a broadly diversified portfolio, there are places for assets in many categories, from many countries, in both *traditional* and *non-traditional* asset classes. Examples include large capitalization stocks (i.e., big, stable companies), small cap stocks (for greater growth potential), investments in the U.S. as well as developed non-U.S. countries, emerging countries for both stocks and bonds, short-term and longer-maturity bonds of all types (e.g., treasuries, high-grade corporates, some lower-grade {high-yield} corporates), preferred stock and master limited partnerships (for the income), some commodities as a hedging device, and so on. In other words, the investment universe is quite large and diverse. True diversification takes advantage of the whole universe.

I have been leaning more-and-more towards companies that pay higher dividends. Especially in times when pure growth may be limited, dividends can provide positive returns. It's still important to wait for the right value situation to buy these stocks, but looking forward, they are a primary focal point.

There are many asset allocation strategies, mine combines a core and satellite approach with some degree of tactical allocation. Simply put, you build a balanced core that essentially remains the same. Around the core, you look for good values that provide increased diversification, along with the potential for increased earnings. As an example, let's say stocks in Canada are really showing strength. One satellite position might be an exchange traded fund (ETF) for Canada. These positions tend to require a more tactical approach, in that the timing of when to move in and when to move out is more crucial.

In addition to a stable core, and satellite positions that might move somewhat more frequently, the decision must be made about whether a fixed income, or even cash, bias makes more sense than an equity bias. Currently, we are in such a period, but that will likely be changing over the next year. Whenever inflation begins (not very likely in the near-term, but almost certain in the future), fixed income and cash holdings are not where you want your money. (This does not mean that those who

hold individual bonds should sell them when interest rates increase. One reason to hold bonds, rather than bond funds, is so you know exactly what your return will be, and you are assured that when the bond matures, you will get the full face amount. The downside to holding bonds is that, if you do sell prior to maturity, you become fully subject to market forces, and the downside can be significant.)

The near future

Recognizing that no one can accurately predict the future, I'm going to take a stab at near-term prognostication. While volatility may calm down somewhat, it will not go away. I also believe that we are in for at least one more down-trend this year. At the same time, I think we are likely to head into the end of the year with an upward trend. I began 2010 thinking that we might be able to get investment returns in the range of 5% to maybe 10% if things went very well. I still hold to that. A good balanced core will produce most of the return, with carefully selected satellite holdings adding the rest.

The U.S. looks to be the most stable investing environment for the near-term. However, certain of the emerging markets are starting to look like they will be able to make some positive additions. Longer term, China will provide good growth, but for now, they are still in a stabilizing pattern. If you have followed China at all, you know that things can change there quickly, so I'll be watching carefully. Countries, such as Brazil and many of the Asian nations, that are closely tied to China may be the better way to take advantage of the growth potential, rather than direct Chinese investment .

I would not be surprised to see gold take a near-term dip. This will present a buying opportunity, because gold (and silver) look to have much more room to grow. Platinum and palladium are two other commodity metals that warrant watching. Both have industrial uses in addition to their place in the jewelry world. Energy and other commodities may be added (most likely through ETFs or funds that invest in a broad basket of commodities) as appropriate.

The various governments may decide to incorporate additional stimulus dollars in their respective economies. To the degree they do, we may see a positive near-term impact. Longer-term, we have to go back to the whole debt situation with all its implications. Shorter-term, a new infusion of capital is likely to be seen by financial markets in a positive light. We'll keep watching.

Wrap-up

That's my mid-year commentary on the economy and financial markets. Overall, I have a positive, albeit cautious, outlook. On a long-term basis, I am very positive, even while recognizing the hurdles that have to be jumped. Shorter-term, I am cautious, but I believe we will end the year on a positive note. Between now and then, I will keep tweaking portfolios to adjust to the current environment. As opportunities present themselves, I will try to incorporate them into the portfolio mix. I'm not going to move into a *trader's* mindset (short-term, market-timing), but I will operate tactically as appropriate.

As always, the purpose of portfolio management is to help you achieve your goals. That is always firmly in mind as the foundation of all investment decisions.

Have a prosperous and successful second-half of 2010.